



*Sent via e-mail: [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov)*

March 9, 2004

Ms. Jennifer J. Johnson, Secretary  
Board of Governors of the Federal Reserve System  
20th Street and Constitution Avenue, N.W.  
Washington, DC 20551

**Re: Docket No. R-1176 Comments to Regulation CC Amendments**

Dear Ms. Johnson:

Northwest Corporate Credit Union (Northwest Corporate) appreciates the opportunity to comment on the proposed rule (Proposal) to amend Regulation CC and its commentary (Commentary) to implement the Check Clearing for the 21<sup>st</sup> Century Act (Check 21 Act).

Northwest Corporate is a \$1 billion corporate credit union headquartered in Portland, Oregon, and serves credit unions in the northwest region of the country. We provide investment, liquidity, and payment system services to credit unions and are part of a network of 30 corporate credit unions, including U.S. Central Credit Union, serving the majority of credit unions around the country.

Many corporates, including Northwest Corporate, process share drafts on behalf of their member credit unions. Credit union share drafts have been truncated for many years. In fact, the credit union industry was one of the first to implement image technology into the normal processing operations. Images are available electronically to credit unions and their members the same day as processed. These images have been used as the equivalent of the original in all cases. Northwest Corporate is very supportive of the Check 21 Act and the proposed changes to Regulation CC.

## **BACKGROUND**

The Check 21 Act will become effective on October 28, 2004. The law will facilitate the electronic exchange of checks by making processing of electronic checks voluntary and not mandatory. The law does not mandate that all financial institutions accept electronic checks, but all institutions must accept a "substitute check" instead of the original share draft or check. The substitute check is the paper copy of the electronic check.

The Check 21 Act also establishes the law for the creation and exchange of substitute checks. The Act covers all checks and makes all of them eligible for conversion, including consumer and business checks, Treasury checks, official checks, teller's checks and traveler's checks. The Proposal on the Check 21 Act would be placed within Regulation CC in a new subpart D and would include the requirements of the Check 21 Act that affect financial institutions that create or receive substitute checks or paper or electronic representations of substitute checks.

Subpart D contains the following provisions:

- The requirements a substitute check must meet to be the legal equivalent of an original check.
- The duties of the financial institution that converts a check into a substitute check.
- The warranties and indemnities associated with substitute checks.
- The expedited recredit procedures for consumers and banks that suffer a loss due to substitute checks.
- The liability for violations of subpart D.
- Samples of the consumer awareness disclosure and other disclosures regarding substitute checks.
- The endorsement and identification standards for substitute checks.

The Board also proposes revisions to several other parts of Regulation CC and its Commentary. Below is Northwest Corporate's response to the Proposal.

### **Legal equivalence for Substitute Checks with MICR Errors**

Northwest Corporate strongly supports treating all substitute checks as the legal equivalent of the original check regardless of whether there is an error in the Magnetic Ink Character Recognition (MICR) line on the substitute check. By choosing to distinguish among MICR line errors and denying legal equivalence to some items, the Proposal introduces new liabilities into the check collection system and will create uncertainty regarding the handling of substitute checks. Even if the MICR line on the substitute check does not accurately represent the MICR line on the original check, the substitute check should still be the legal equivalent of the original check, regardless of whether the error is in the amount field or some other field.

Credit unions that collect or pay substitute checks and the consumers that receive them should know that they could process substitute checks and treat them as the equivalent of the original check. If a substitute check were not the legal equivalent, then a paying credit union would have no authority to charge its member account, even if the paying credit union could determine that the substitute check was otherwise properly payable, regardless of the MICR encoding error. A collecting credit union would have no authority to repay the substitute check or to present the check to the paying credit union to obtain payment. Consumers should be able to rely on the substitute check as the legal equivalent of the original check for proof of payment.

The final rule should require a reconverting bank to print the MICR information from the original check in MICR ink on every substitute check it creates. The MICR line from the substitute check should contain all the information from the original check. If the reconverting bank does not place the entire correct MICR line on the substitute check, then it has breached the Check 21 Act

warranty requirement that it “accurately represents all of the information on the front and back of the original check” as required under Sections 4 and 5 of the Act.

### **Encourage MICR Repair on Substitute Checks**

Northwest Corporate supports revising the Proposal to ensure that the reconverting bank, collecting bank and returning bank can repair a MICR line on a substitute check without incurring additional liability under the Check 21 Act, which discourages them from repairing misencoded MICR lines on the substitute check. In order to do this, the final rule should allow the reconverting bank to repair a MICR line on a substitute check after it creates that substitute check.

If the reconverting bank does not place a MICR line on a substitute check that matches the original check’s MICR line and another credit union or consumer experiences a loss, then the warranties and indemnities under the Check 21 Act as written should and would protect that person. The warranties and indemnities under the Check 21 Act from the reconverting bank will protect subsequent parties to the extent any liability arises from the receipt of a substitute check with MICR line information that does not “accurately represent” the MICR line information on the original check.

Northwest Corporate believes the Proposal should encourage collecting and paying financial institutions to treat and repair the MICR lines on substitute checks in the same manner they would treat and repair original checks. As a result, the Proposal should provide that a collecting credit union or a paying credit union could voluntarily repair any portion of a MICR line on a substitute check that it receives in the check collection process. Although these repairs should be allowed, they should not be mandatory. When a collecting or paying financial institution does repair a substitute check, that repair should not invoke the Check 21 Act warranties, regardless of whether it is done correctly or not or whether the full or partial MICR line is placed on the repaired substitute check. Instead, the collecting or paying financial institution that repairs a substitute check in a manner that results in an inaccurate MICR line would breach the encoding warranties under the Uniform Commercial Code (“UCC”) and Regulation CC.

### **Address Inconsistent Liability Among Reconverting Banks**

Northwest Corporate requests that the Federal Reserve revise the Proposal so there is equal liability among the first and second reconverting bank when the first reconverting bank does not provide notice that it is creating a substitute check. The failure of a reconverting bank or a collecting bank to correctly encode position 44 could result in an illegible substitute check further down the collection chain. The Federal Reserve should specify in its Commentary that the error of the first reconverting bank to properly encode position 44 of the MICR line make it liable for breach of the Check 21 Act warranties.

### **Definitions and Standards**

Northwest Corporate supports the new definition of “transfer and consideration”. Section 229.2(bbb) clarifies that a “transfer” includes the transfer of a substitute check from a paying financial institution to its customer and that the Check 21 Act applies to the paying bank’s creation

and transfer of a substitute check to its customer. Northwest Corporate believes that paying financial institutions should have the option to deliver substitute checks to their customers.

Northwest Corporate agrees that the Federal Reserve should refer to general industry standards in the regulation and mention specific standards in the Commentary. If the Federal Reserve uses this approach, it could adapt to changes in industry standards by amending the Commentary without needing to change the general standard in the regulation. Northwest Corporate believes that the financial sector should rely on a specific set of standards so that substitute checks are uniform.

### **The Proposal Should Apply to the Check 21 Act Substitute Checks Warranties**

Northwest Corporate supports the exclusion of duplicative ACH debit payments from the Check 21 Act warranties. A second charge to an account resulting from an ACH debit entry initiated using an original or substitute check should not be subject to the warranties under § 229.52(a). The ACH rules already provide that an originating depository financial institution warrants that the ACH debit entry is authorized and may be returned for recredit if a consumer claims it is unauthorized. Therefore, it is unnecessary to subject an originator of an ACH debit entry to a second set of warranties under the Check 21 Act.

The expedited recredit provisions of the Check 21 Act should not apply to UCC warranties as it is specified under the Proposal. Under the Check 21 Act, for a consumer to make a claim, they must allege that they have a “warranty claim with respect to such a check”. We assumed that the warranty claim the Act referred to was a warranty claim found within the Check 21 Act. The Commentary states in Section 229.54(a)(2) that a consumer has the right to an expedited recredit claim for a breach of UCC warranties with respect to a substitute check. The expedited recredit rights in the Check 21 Act should be limited to circumstances presented within the Act itself. Consumers are fully protected from breaches of UCC warranties under the UCC.

### **Consumer Disclosures**

Northwest Corporate supports the inclusion in the Proposal of sample notices for situations in the Check 21 Act that require notice. We suggest that the Federal Reserve specify in its final regulation that the Federal Reserve consider the use of these notices by a financial institution to constitute compliance with the Check 21 Act. The Federal Reserve’s support of its own notices would provide support for a finding of compliance by a court or alternative forums.

### **Unrelated Regulation CC Amendments**

Northwest Corporate does not support reducing the timeframes for notice of nonpayment for checks in the amount of \$2,500 or more.

Northwest Corporate supports requiring the disclosures in Regulation CC to be consistent with the requirements of the Electronic Signatures in Global and National Commerce Act (the E-Sign Act) and supports adopting language that clarifies the acceptability of e-mail.

Northwest Corporate supports the Federal Reserve's proposal to more clearly define "local bank". Regulation CC distinguishes between local and nonlocal items in terms of the deadlines for funds availability. To clarify how an item is considered, the Federal Reserve proposes to amend the commentary for the definition of "local paying bank" (12 CFR § 229.2(s)) to provide additional detail on how to determine when deposits mailed to a central check processing facility are local or nonlocal.

Northwest Corporate supports the Proposal to clarify the current rule regarding extension of the midnight deadline. The UCC requires a payor bank that wishes to dishonor a check to dispatch it either to the depository bank or to a returning bank for forwarding to the depository bank by midnight on the next banking day after the banking day on which the payor bank had received the check. Failure to make the deadline requires the payor bank to pay the check. The current rule allows extension of up to one day when a paying financial institution uses a means of delivery that ordinarily would result in receipt of the check by the receiving bank's next "banking day".

In a recent court case, the court interpreted the current provision to permit an extension of the midnight deadline even when the check was received by a returning bank at a time that was too late for the bank to process the check that day. In effect, the court found that a Federal Reserve Bank, the returning bank in this case, has no end to its "banking day" and thus allowed a return up until midnight of the day following the midnight deadline. The proposed amendment to Regulation CC would effectively overrule this decision and make it clear that the check must be received by the returning bank's cutoff hour for the next check-processing cycle (if sent to a returning bank). Northwest Corporate supports this change.

## **Conclusion**

Thank you for the opportunity to comment on the Proposal to implement the Check 21 Act. If you have any questions, please contact me at 1-888-688-6788, ext 6316.

Sincerely,

Kathy L. Garner  
President/CEO